Events since that decision have further validated the FCC's concerns. The price-leader/follower pattern that the long distance industry repeatedly manifested before the order in the Non-Dominance proceeding continues. As the pricing for large accounts clearly attests, this is hardly the kind of performance one would have expected from an increasingly competitive industry—and particularly one characterized by dramatic technological progress.

III. ACCESS CHARGES

MCI repeatedly claims that existing access charges represent a threat to competition (apparently in long distance markets, but MCI is not particularly clear) because they are too high.

While it is obvious that it is in MCI's economic interest to argue for lower access charges, it is not clear how current rates are anticompetitive given that all competitors, including the long distance affiliates of LECs, are subject to the same charges under the non-discrimination provisions of the Telecommunications Act of 1996 (the Act). MCI claims that access charges are above cost (although it does not define economic cost) resulting in the LECs receiving unjustified "subsidies" from long distance providers. The implication of the MCI claims appears to be that LECs could engage in cross-subsidization of under-priced long distance services effecting a "price squeeze"; they could not. The imputation rules, accounting safeguards and separate affiliate requirements of the Act are specifically designed to make such practices impossible.

The Act requires a RBOC to provide in-region interLATA services through a separate affiliate[47] for three years after the date it is authorized to provide interLATA services, unless the requirement is extended by the FCC.[48] A separate subsidiary requirement is a strong safeguard because it exposes inter-subsidiary transactions to even greater scrutiny than the already

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[47] § 272(a)(2)(B).

[48] § 272(f)(1).

effective FCC accounting rules would.[49] In addition, as interpreted by the FCC, under the separate subsidiary requirement, an RBOC long distance affiliate can resell packages of RBOC and IXC services or purchase unbundled elements, i.e., transport and tandem switching to combine with its own or leased interLATA transport and switching facilities or build its own new network. According to the FCC, preventing use of the existing intraLATA RBOC networks as part of an integrated intra- and inter- LATA system will prevent misallocation of long distance facilities costs to the basic ratepayers. In either case, the Act's structural safeguards, nondiscrimination and auditing provisions, and the FCC's rules on affiliate transactions and unbundling will effectively prevent any RBOC from taking advantage of its position.

MCI's asserts that access charges are too high is not supported with any discussion of the underlying economic costs of access.

To say that access charges should be set at cost is meaningless without defining cost. MCI asserts that access charges should be brought down from 6 cents to less than 1 cent. MCI claims that this would be consistent with the forward looking methodology employed by the FCC. The order implementing this methodology, known as TELRIC, is currently stayed by the United States Court of Appeals for the Eighth Circuit[50] precisely because the LECs (and others) dispute that access charges at this level are in the public interest.

Access costs set at TELRIC would damage the prospects of facilities based entry into local markets, by making it difficult for private investors to earn a competitive rate of return on new investment, thereby delaying and diminishing the extent of competition. It would also create stranded investments in the hands of prior investors, no longer able to recover the costs

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[49] In addition, the Act limits the ability of both BOCs and IXCs to jointly market certain interLATA services and local exchange (§§ 271(e)(1), 272(g)). However, unlike the LEC, competitors can sell both interLATA and intraLATA services prior to the LECs interLATA entry.

[50] Iowa Utilities Board, et al. Petitioners v. FCC, USA, Respondents. Order Setting Hearing and Imposing Temporary Stay, United States Court of Appeals for the Eighth Circuit, September 27, 1996.

of infrastructure in place. Changing the "rules of the game" by restricting private investor's ability to earn a just and reasonable return on assets in place would raise the cost of capital attenuating the incentives for future investments in innovative new technologies.

To potential entrants into the local exchange market, TELRIC based prices would offer them the use of incumbent facilities at rates equal to the cost of the "most efficient technology available."[51] The alternative of facilities based entry would be unattractive since, except for possible quality or brand name advantages of their own facilities, competition with incumbents and competitors at TELRIC rates would provide no margin to deliver a reasonable rate of return to prospective investors.

To incumbent LECs, TELRIC based prices would preclude the recovery of capital costs embedded in the existing network, to the extent that these costs exceed the corresponding forward looking charges for depreciation and cost of capital associated with a network composed of the "most efficient technology available".[52] Furthermore, TELRIC would set rates below operating costs of their existing network, due to it being older less efficient technology, and due to the diminished scale and scope economies not accounted for in rates. Incumbent LECs would face the same attenuated incentive to invest in new technology as potential entrants.

To both potential entrants and incumbents alike, the reaction of the capital markets to the regulatory restriction of access charges to levels that leave private investors with stranded assets would raise the perceived risks of investing in innovative new telecommunications technologies. To compensate for this increased risk the market would impose higher cost of capital, which ultimately would be passed on to consumers but might also make some otherwise viable investment projects uneconomic.

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[51] FCC Order, paragraph 690.

[52] *Ibid.*

IV. IMPACT OF RBOC ENTRY INTO LONG DISTANCE

MCI claims that the long distance market is already competitive and that LEC entry would damage this competition. MCI also claims that where LECs have already started to offer long distance they have not competed by lowering costs.

MCI's excessive protestations betray the true motivation for its appeal: to maintain the excess profits that it enjoys as a consequence of incumbency in an oligopoly market. MCI presents only flimsy hypothetical support for its appeal that incumbent long distance providers should continue to be protected from RBOC entry.

RBOC entry into long distance would deliver competition beyond the existing levels described by MCI. Examples of LEC entry in long distance to date demonstrate that LECs have delivered benefits to consumers and extended competition.

A. The Nature of LEC Competition in Long Distance

RBOCs have different product, revenue and cost structures from incumbent long distance providers, that would change the balance of competition delivering additional economies of scope and scale and destroying the existing oligopolistic balance between competitors currently in the market.

1. Economies of Scale and Scope

Even though FCC rules prohibit joint ownership and control of a single integrated network to provide long distance and local services, when interLATA relief is granted, consumers will benefit from a number of efficiencies. First, joint marketing will be allowed by all competitors. This could result in savings in administrative costs and marketing costs.[53]

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[53] As interpreted by the FCC, under "Joint Marketing", 47 U.S.C. § 272(g), "a BOC and a section 272 affiliate may share in-house services with each other only to the extent that such sharing is consistent with sections 272(b)(1), (continued...)

There are three potential sources of economic efficiencies from economies of scale and scope: (i) as indicated above, price competition is apt to be more intense following entry, and this would result in expanded use of telecommunications networks; (ii) as the FCC found, "...the increased flexibility resulting from the ability to provide both interLATA and local services from the same entity serves the public interest, because such flexibility will encourage section 272 affiliates to provide innovative new services;"[54] and (iii) 272 affiliates and other competitors[55] may build vertically integrated networks using new local facilities[56] or via purchase of unbundled elements from an RBOC's current intraLATA network.[57] In each of these cases, telecommunications networks would be used more extensively and, thus, lower unit costs could be achieved. The large number of recent mergers and joint ventures throughout the telecommunications industry further suggests that current-sized firms do not exhaust the available economies of scale and scope.[58]

Third, outside of its region, an RBOC can buy network capacity from other, non-affiliated carriers, as could an RBOC's 272 affiliate within the RBOCs region. RBOCs may be able to negotiate better wholesale rates from such carriers, including IXCs, than current resellers have done and, thus, exert greater pressure on current, high IXC profit margins. This is because: (i) RBOCs presents a more credible threat of facilities-based competition to IXCs in

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(...continued)

272(b)(5), and 272(c)(1) of the Act." Paragraph 180, First Report and Order and Further Notice of Proposed Rulemaking, In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended, CC Docket No. 96-149, Released: December 24, 1996. (NPRM Non-Accounting Safeguards).

[54] NPRM Non-Accounting Safeguards, paragraph 315.

[55] In this case other competitors could include IXCs.

[56] The concentration of business in the local market may make it economically feasible for 272 affiliates or other competitors to build their own local switching facilities.

[57] As long as the threat to build competing facilities is credible, incumbent LECs would have an incentive to lower their unbundled rates to a level just low enough to make the construction of new facilities unattractive. Thus the make-buy decision will tend to favor purchase of unbundled elements unless capacity constraints bind or new technology with lower operating costs becomes available.

their markets than resellers or smaller competitors; and (ii) RBOCs has brand name recognition, financial resources, technical know how and joint marketing capabilities all contribute to making it better able to negotiate more favorable rates.

Finally, greater competition will force the IXCs to operate more efficiently and to innovate more rapidly. To the extent that IXC costs are currently above efficient TSLRIC for toll service, IXCs would also be forced to upgrade their networks, or risk losing market share to new facilities-based competitors.[59] Furthermore, BOC entry should destabilize the IXC oligopolistic equilibrium and should provide an additional incentive for each IXC to offer local service as rapidly as possible lest it lose its competitive position in the marketplace. Therefore, RBOCs entry is likely to bring lower rates and accelerated infrastructure development for long distance and local services to the benefit of consumers.[60]

2. The Unique Competitive Role of LEC Entry

Although the Act opens telecommunications markets to all on a non-discriminatory basis, it is unlikely that the economic efficiency gains described above would be maximized if BOCs' entry into interLATA markets were impeded, for several reasons. First, the current oligopolistic characteristics of the interLATA market give IXCs less incentive to seek out these economies than they would have when the equilibrium is disturbed by RBOC entry.

(...continued)

[58] These mergers and agreements are either combinations of companies with similar services, but operating in different geographical areas, or combinations of companies operating in overlapping areas, but offering different services.

[59] This is true of facilities-based competition or the viable prospect of facilities based entry by a strong competitor such as RBOCs.

[60] Note, however, that LECs cannot count on long distance revenues to offset fully local losses, because greater competition for long distance service will reduce profit margins from those services.

Second, other smaller competitors would be less able to generate the potential economies due to their smaller scale, weaker brand recognition, scarcer financial resources for innovation and product development, and less developed joint product marketing capabilities.

Third, because RBOC entry would disrupt the IXCs' market equilibrium, competitive market dynamics (and, thus, technological change) would be accelerated in both local and long distance upon RBOC entry.

Fourth, the fundamental make or buy decisions faced by firms entail comparisons of the transactions cost of using the price mechanism with the cost of organizing those activities through direct managerial control. Delaying RBOC entry could distort this market process and lead to resource misallocation because artificial regulatory limitations on the ability of firms to take advantage of integration hinder productive efficiencies and could cause excessive use of unbundled network elements with excessive transactions costs. Ultimately, the Act can only deliver more competitive markets if competitors who present a real threat of significant competition are allowed to participate in those markets. As long as RBOC entry is delayed, so will be the principal benefits of reform.

B. Examples of LEC Entry

MCI claims that over RBOCs have failed to demonstrate that they can enter a competitive market, compete fairly and provide significant consumer benefits.

LEC competition in long distance markets has generated substantial benefits to consumers.

- As of July 22, 1996, SNET's prices for non-discount customers in Connecticut was 29.8 percent lower than AT&T's and 10.6 percent lower for discount customers. Across all customers, SNET's prices were about 22 percent lower.[61] According to one estimate,

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[61] Hausman, Jerry, Hearing "Economic Forum: Antitrust And Economic Issues" held at July 23, 1996 at the FCC, pp. 69-70.

SNET's market share of Connecticut's long distance market was 25 percent in September 1996, most of which was yielded by AT&T.[62]

- By September 1996, GTE was adding 9000 subscribers a day in the 21 states where it offers long distance service[63] and had increased its customer base to 300,000.[64] In line with its predictions for 1996 year-end, GTE has reached a customer base of 750,000[65] and hopes to double this number during 1997. In its filing with the SEC, GTE stated that it expects to increase its long-distance revenue sevenfold in 1997.[66]

- With the passage of the Act, SBC began offering its then-3.7 million cellular customers a flat rate of 20 cents per minute for the long-distance portion of a call. At the time, AT&T and others were charging customers about 34 cents per minute.[67] This represents about a 40 percent reduction.

- Ameritech signed up 250,000 cellular long-distance customers in the first two months of its offer.[68]

- In May of 1996, BellSouth, SBC, and PacTel formed a buying consortium to resell AT&T's and other IXCs' long-distance service at higher discounts. The terms of this pact allow the three Bells to separately price and package their long-distance services.[69]

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[62] Naik, Gautam, "Going Long: The Baby Bells All Have Their Sights Set on the Long-Distance Market; But Each Has Its Own Invasion Plan," *The Wall Street Journal*, September 16, 1996, p. R12.

[63] "Bells, GTE Lay Out Marketing Strategies, Swap Success Stories at New York Conference," *Telecommunications Reports*, September 26, 1996.

[64] Naik, Gautam, "Going Long: The Baby Bells All Have Their Sights Set on the Long-Distance Market; But Each Has Its Own Invasion Plan," *The Wall Street Journal*, September 16, 1996, p. R12.

[65] Naik, Gautam, "GTE to Offer Flat-Rate Calling Plans In Aggressive Bid For Corporate Users," *The Wall Street Journal*, December 18, 1996, p. B8.

[66] Keller, John J., "GTE Is Upbeat About Earnings For Next Year," *The Wall Street Journal*, November 18, 1996, p. B3.

[67] Naik, Gautam, "Measure Provokes Threats By Firms Of Invading Each Other's Business," *The Wall Street Journal*, February 9, 1996, p. B3.

[68] Naik, Gautam, "Going Long: The Baby Bells All Have Their Sights Set on the Long-Distance Market; But Each Has Its Own Invasion Plan," *The Wall Street Journal*, September 16, 1996, p. R16.

[69] Cauley, Leslie, "BellSouth Corp. Awards AT&T Contract...Sprint Is Closing Long-Distance Pacts From PacTel and SBC," *The Wall Street Journal*, June 20, 1996, p. B6.

V. EVOLVING COMPETITION IN LOCAL MARKETS

A. The Need For Competitive Parity

MCI implies that for competitive parity to be achieved LEC access to the long distance market should only be granted once competition in the local market has developed to the level observed in the long distance market.

This is a blatant appeal for preservation of the status quo. Equalization of the levels of competition is the outcome of establishing competitive parity not its prerequisite. Competitive parity is achieved by providing reciprocal access to local and long distance markets. Long distance providers already have access to local and intrastate toll markets through interconnection, unbundled elements, resale services and local number portability. Local exchange companies by contrast are still excluded from long distance markets where the big three IXCs, AT&T, MCI and Sprint, dominate.

The LECs are required to negotiate resale and unbundled rates to allow long distance providers to offer local services.[70] Many resale and unbundled access agreements and tariffs are already in place[71] and furthermore the Act provides a framework for compulsory arbitration to ensure that LEC obligations to provide resale or unbundled elements on a non-discriminatory basis are met in a timely manner upon receiving a request.[72]

Maintaining the current system of asymmetric competition, handicapping RBOCs, harms competition, reduces economic efficiency and, thus, does not serve the public interest. Such asymmetries, especially outright entry restrictions on <u>one</u> class of competitor, coupled with allowing entry into that competitor's market, result in unfair—not effective—competition. Under these circumstances, customers will not enjoy the benefits of effective competition.

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[70] 47 U.S.C. §252.

[71] For instance, a year after the passing of the 1996 Act, AT&T has 52 local phone pacts in 38 states, MCI 31 pacts in 26 states and Sprint, 29 pacts in 29 states.

Such policies could inefficiently encourage expansion by firms which are less efficient at providing intraLATA toll service and weaken the regulated firms' ability to compete by interfering with their development of innovative product offerings.

Long distance providers enjoy a further advantage over LECs that MCI ignores when discussing issues of competitive parity. Entrants into the local market have the opportunity to "cherry pick" low cost, high volume customers for local by-pass while LECs have existing sunk investments that they were required to make to relatively higher cost customers. As intraLATA competition expands, entrants will target the LECs' most profitable customers and services; thus, they need not provide ubiquitous service using their own networks to compete effectively. Indeed, by offering the most advanced broadband and wireless services in combination with interLATA toll, they will target the most lucrative customers.

The conditions of competitive parity desired for the constructive advancement of competition are not dependent upon perfect symmetry across markets and between competitors, but upon equal opportunity to compete on a non-discriminatory basis.

B. Competitive Disparity From Delay in RBOC Entry

MCI argues that LEC entry into long distance should be delayed because, combined with their position in the local market, entry would grant LECs at a competitive advantage over long distance providers. Specifically MCI claims that only the LECs are able to provide bundled services.

Under the Act, competitive parity is achieved through reciprocal market opening. RBOCs that wish to enter the long distance market must provide interconnection and access to unbundled network elements, to competitive telecommunications carriers and allow resale of its services at wholesale (discounted) rates under nondiscriminatory terms and conditions.

(...continued)

[72] 47 U.S.C. §252(b).

Current levels of local competition do not indicate anything about the ability of long distance providers to compete in local markets. The unbundling and resale provisions of the Act give competitors the ability to enter the market rapidly on a broad scale with relatively low initial investments. The limited evidence of IXC entry into the local market to date suggests that long distance providers have merely delayed entry for strategic reasons.[73]

Contrary to MCI's claim there may in fact be a "first-mover advantage" for the existing IXCs rather than for LECs. Long distance service providers are able rapidly to add local service to their current offerings of intra- and interLATA toll services. Indeed, they have already made substantial strides and some do so now while others are poised to do so directly. This advantage can only grow as entry is delayed and preparations for rapid market entry are further advanced.

The "new intraLATA entrants," especially the IXCs, are well-established national and international firms that already provide services to all the BOCs' customers. The IXCs' substantial marketing campaigns and customer relationships have put them in a strong position to compete to provide all telecommunications services. According to *Advertising Age*, the results of a recent Yankee Group survey show: "AT&T is the Bell of the ball. No matter where they live, consumers would prefer AT&T if they could choose one company for local and long-distance service."[74]

Some have argued that RBOCs are better positioned ultimately to provide the full package of local and toll services because of their ubiquitous network; however, this flawed argument clearly does not justify maintaining the current interLATA ban. Although the RBOCs have fiber in their toll networks and have begun to use some in their feeder plant, their

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[73] "'The perception among regulators is that once AT&T gets into local we'll have real competition,' says Terrence Barnich, a former Illinois regulator. Thus, by deliberately holding back, AT&T could successfully delay the Bells' entry into long distance, he reasons." (Cauley, Leslie, "Big Carriers Are Slow To Enter Local Markets," *The Wall Street Journal*, January 28, 1997, p. B1.)

[74] "AT&T Ringing Up 5 Regional Units," Kim Cleland, *Advertising Age*, December, 11, 1995, p. 3.

alleged technological "advantage" is predicated on the ubiquity of a largely outdated copper local network. In contrast, competitors have installed broadband coaxial and fiber networks, as well as wireless networks. They are extending these to provide local service using LEC network components where it suits their goals, and their own new and existing infrastructure, in other areas. The LECs remain saddled with underdepreciated, technologically dated copper wire plant.

C. Emerging Competition from Wireless and Cable

MCI implies that in spite of announcements and trials cable and wireless services will provide a little competitive pressure on incumbent LECs in local markets.

1. Local Competition From Wireless

Market evidence including the acquisition activities of long distance providers indicate that wireless is a viable substitute for local wireline service. The versatility of PCS units--the ability to be used as cordless phones at home or in the office and like cellular phones while traveling--will likely propel PCS and other wireless (i.e., cellular) services to become competitors of LECs.[75] The digital technology incorporated into PCS (and increasingly into cellular systems) permits an array of services that can match or exceed what is being offered in landline service and current cellular service.[76] The substitutability of wireless for wireline is indicated by the fact that 60 percent of cellular customers have used their wireless phones to make calls that they could have made on a wireline phone.[77]

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[75] The mobile wireless services described in this section include cellular (825 - 894 MHz range), PCS (1.85 - 1.99 GHz range) and Specialized Mobile Radio (various bands in the 800 and 900 MHz range).

[76] The digital platform of PCS, and increasingly cellular services, has allowed the introduction of information services that are transmitted to the phone and read from its alpha-numeric display. PCS units can receive short e-mail messages, pages, stock quotes and news headlines. "Who needs a cell phone?," *Consumer Reports*. February 1997, p. 12.

[77] "Who needs a cell phone?," *Consumer Reports*, February 1997, p. 14.

A recent *Business Week* article provides strong evidence that AT&T and the other major IXC's plans to bypass local BOC networks have a large wireless component:

> *"...wireless [is] an attractive alternative for giants such as AT&T that desperately want into the $105 billion local calling market. And, according to numerous sources that is just what AT&T is preparing to do. The company which became the nation's largest cellular operator with the purchase of McCaw...is furiously working on technology that would allow it to bypass the wired network in cities and towns across the nation. AT&T is not the only carrier considering wireless for local calling. Sprint Corp., whose Sprint PCS venture began rolling out a 65 city PCS mobile-phone network in December, has said it eventually would like to use PCS for local access, too.*
>
> *...hints of [AT&T's] intentions can be seen in AT&T's aggressive bidding in auctions for PCS spectrum now under way at the Federal Communications Commission. Through AT&T Wireless Services (formerly McCaw), the company paid $1.7 billion in 1995 to buy 21 PCS licenses and traded for two more in 1996. Now it's bidding more than $400 million for additional airwave capacity...."*[78]

There are similar developments in other companies' efforts to use their wireless capabilities in the provision of local service:

- MCI agreed to purchase substantial wireless mobile and fixed services from NextWave. According to MCI, NextWave's plan for wireless local loop service is a key part of the agreement. MCI stated "we want to have every weapon in our arsenal to go after that [local calling] market, and clearly, wireless local loop is one of those."[79]

- SBC Communications Inc. began offering bundled services, "local and long-distance landline and wireless service, paging and Internet access," under the Cellular One brand name in Rochester in early January 1997.[80]

- Winstar launched its wireless service in November 1996 over its "wireless fiber" network. Winstar offers local loop service, resale long distance and high-speed data

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[78] "Vaulting The Walls With Wireless," *Business Week*, January 20, 1997, pp. 85-88.

[79] "MCI Aligns with NextWave for Fixed and Mobile PC," *Multichannel News*, September 2, 1996, p. 40.

[80] "Dynamex buys 3 same-day delivery services," *Dallas Morning News*, January 7, 1997, page not available.

links.[81] Winstar is hoping to attract small and medium businesses by providing bundled services and local service at 25% below LEC rates. Winstar "will use its own wireless technology to carry local phone and data calls over small rooftop antennas."[82] Winstar currently advertises its ability to provide "local, long distance and Internet services to small and medium-size businesses."[83]

Not only will PCS entry put downward pressure on prices for all forms of wireless access to the telephone network but it will also improve service quality and exert pressure to add new features. As a result, wireless services will compete even more effectively with local wireline services from BOCs since consumers will increasingly see wireless service as a substitute for wireline service.

2. Local Competition From Cable

The prospect of entry into video services by the phone companies has increased the incentive for the cable TV companies to accelerate their entry into phone services. Currently much of the entry into local switched access markets by cable firms has been through CLEC subsidiaries. The cable firms earn valuable experience at providing local service and competing in the local market through their subsidiaries.

Cable TV companies are clearly positioning themselves as competitive alternatives to RBOCs. While cable firms are announcing a more cautious entry into local exchange markets then predicted earlier, the National Cable Television Association (NCTA) announced on January 30, 1997 that the cable TV industry "'remains committed to the long-term goal' of using its networks to provide a full range of telecom services."[84] In addition, the NCTA stated that "Cable TV operators spent more than $2.6 billion to construct networks capable of carrying

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[81] "Winstar to Offer Local Service Opposite NYNEX," *Telecommunications Alert*, November 13, 1996, page not available.

[82] *Ibid.*

[83] Winstar advertisement.

[84] "NCTA's Anstrom Says LECs are 'Stonewalling,'" *TR Daily*, January 30, 1997.

two-way traffic and have laid plans to spend another $2.7 billion this year."[85] They are installing fiber-cable into their networks at a rapid pace, adding capacity, improving quality and reliability, and forging alliances in preparation for direct, head-to-head competition with local phone companies.

Despite reports that Time Warner is scaling back its telephone investment,[86] Time Warner President Thomas Morrow stated that the company has "'no intention of abandoning [its] business customers.'"[87] Time Warner has also recently placed an order for one million new digital set-top boxes that increase channel capacity, provide Internet access and could be linked to its RoadRunner cable modem service.[88] Time Warner is also continuing:

> *"more aggressively [to] upgrad[e] its wires and central computers. By the end of the year, a third of all Time Warner cable systems will be upgraded for two way services such as video-on-demand and telephone communications. The company expects to complete half its system upgrade by 1997 and the rest by the end of 1999.*[89]

This announcement after news of Time Warner's hesitancy, is evidence of Time Warner's intention to go ahead with its plan, announced in July 1996, to invest $500 million over the next four years to upgrade its coaxial cable network.[90] Furthermore, Time Warner has signed an agreement with AT&T to provide dedicated and switched local phone service for business services with AT&T.[91]

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[85] *Ibid.*

[86] "Time Warner busy revising phone plans," *USA Today*, October 9, 1996, p. 1B.

[87] *Ibid.*

[88] Wasserman, Todd and Gregory Quick, "Western Cable Show, Anaheim CA - Companies hooked on PC - Cable TV," *Computer Retail Week*, December 16, 1996, p. 5.

[89] Robichaux, Mark, "Time Warner Inc. is Expected to Buy New Set-Top Boxes," *The Wall Street Journal*, December 10, 1996, p. B10.

[90] Landler, Mark, "Cable Concern Plans a Fight Against NYNEX." *The New York Times*, July 10, 1996.

[91] "AT&T Announces Agreements With Five Companies to Provide Access To AT&T Customers in 70 Cities," *Business Wire*, April 11, 1996.

There are many other examples of emerging competition from cable companies.

- Cablevision Systems, the nation's sixth largest cable television is planning to offer dial tone and Internet access over its OptimumTV cable system. Currently, Cablevision Lightpath, Cablevision's new, local telephone unit, services about 450 Long Island businesses through fiber-optic cables.[92] By the end of 1995, after roughly one year in operation, Lightpath's digital switching facility hit one million minutes of switch traffic per day, an increase of 2,500% compared to 1994, and had $15 million in annual revenue.[93]

- Hyperion Telecommunications, owned by Adelphia, is a CLEC that provides access services in thirteen markets in eastern states.[94] It hopes to begin service in 1997 in areas where Hyperion already has a significant amount of fiber in place.[95] Also, Adelphia is planning to offer local phone service in the Buffalo area in the spring of 1997, over the same network that delivers its cable service. The company will focus on residential customers who are already its cable subscribers.

- TCG, which is owned by Tele-Communications, Inc. (TCI), Comcast Corporation, and Cox Communications, is certified as a CLEC in 30 markets.[96] TCG began a trial in the fall of 1995 of voice telephone services outside Chicago using hardware from Motorola, Inc. with a TCI-supplied fiber/coaxial net.[97]

- Cox Fibernet, owned by Cox Cable, is certified to provide local phone service in three metropolitan areas. Norfolk, VA, New Orleans, LA, and Oklahoma City, OK.[98]

- Jones InterCable Inc. signed an agreement with Bell Atlantic Corp. enabling it to offer packaged telecommunications -- video, telephone and internet access. It has received

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[92] *Ibid.*

[93] "Local Competition: Cablevision Lightpath Celebrates Year of Sizable Growth in 1995; Cablevision Systems' Telephony Subsidiary Hits One Million Switched Minutes a Day Milestone," *Business Wire*, December 15, 1995.

[94] "CLEC Hyperion Files for $150 Million in Financing," *Bloomberg News Service*, April 3, 1996; *Telecommunications and Advanced Services Presented by the Cable Industry*, National Cable Television Association, April, 1996, p. A1.

[95] "Hyperion Will Use NYNEX, Cable Plant in Vt.," *Multichannel News*, August 12, 1996, p. 4.

[96] *Telecommunications and Advanced Services Presented by the Cable Industry*, National Cable Television Association, April 1996, p. 15.

[97] Greene, T.M., "Cable Firms Creep Toward Rollout of Local-Loop Service," *Network World*, September 11, 1995, p. 1.

[98] *Telecommunications and Advanced Services Presented by the Cable Industry*, National Cable Television Association, April, 1996, p. 14.

approval from Virginia regulators to offer local telephone services in Northern Virginia.[99] Jones believes that it can offer service at 20% below Bell Atlantic rates.[100]

These developments show that competition to RBOC wireline service will erode whatever market power it would otherwise have had. Thus, whatever incentive to discriminate in the provision of access RBOCs could have today, absent the regulatory safeguards discussed above, will be rapidly eroded by competition and the unbundling requirements of the Act.

D. Effectiveness of Safeguards

MCI implies that the regulatory safeguards will be insufficient to ensure that RBOC entry into long distance markets will enhance competition since RBOC's may use delaying tactics or otherwise inhibit mandated local market opening measures and cross subsidize long distance services.

Successful experience with regulatory safeguards for RBOC participation in unregulated markets in the past shows that banning or delaying entry is not needed to protect competition. Years of experience since divestiture of the BOCs operating in associated telecommunications markets in competition with other companies, indicates no evidence that BOCs have prevented or suppressed competition in any of those markets. Assertions about the theoretical inadequacies of regulatory safeguards against predation, cross-subsidy and discriminatory treatment of competitors simply ignore the abundant historical evidence to the contrary.

In practice, competition by non-vertically integrated firms with BOC "bottleneck monopolies" has already succeeded in parts of other telecommunications markets that are equally or more susceptible to anticompetitive tactics than the interexchange market: these include cellular, voice messaging services (VMS), corridor and intraLATA long distance services.

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[99] Price, Colman, "Jones gets telco OK in Virginia," *Broadcasting and Cable*, July 8, 1996.

[100] "Alexandria Cable Firm To Offer Phone Service: Company Would Compete With Bell Atlantic," *The Washington Post*, February 17, 1996, p. B1.

- In certain specific instances, (e.g., the New York and Philadelphia corridors) the BOCs have routinely provided interLATA services since divestiture. Over thirteen years have passed since divestiture without discernible adverse consequences.[101] Also, such large LECs as GTE, United Telephone, and Rochester Telephone (now Frontier) have offered interLATA services for years without apparent anticompetitive effect.

- LECs have participated in cellular telephony since 1983. Despite their "head start," they have not come to dominate the market, as would have happened if they had subsidized these services from their local telephone services or discriminated against their competitors. Despite starting operations after the local exchange carriers, non-wireline suppliers have nearly equal market shares.[102] Though the LECs are presumably the most knowledgeable about the real risks of anticompetitive conduct by incumbent wireline cellular carriers, the number of territories in which LEC cellular affiliates have entered to compete with one another has grown rapidly from about 5 in 1986 to more than 30 in 1995.[103] AT&T sunk billions into this market through its purchase of McCaw. This is powerful evidence that concern that LECs might be able to discriminate in favor of their cellular affiliate in their home territories has not been a deterrent to entering into competition with them. It also strongly suggests that such alleged discrimination simply has not materialized.

- Many LECs have long been allowed to provide information services, without evidence that competition has been undermined. Since the BOCs and GTE began offering VMS, consumer welfare has increased in at least two ways. First, the monthly charge has dropped from $30 in 1990 to $5-$15 in 1995.[104] Second, the LECs began offering VMS to an untapped market segment—residential and small business customers. In five years, the BOCs' participation in this market increased from zero to over six million subscriptions, yet competitors have thrived and the BOCs and GTE together account for just over 15% of total VMS revenues nationally.

- Finally, most states permit intraLATA toll competition. If competition in the presence of bottleneck facilities gave rise to uncontrollable discrimination, these markets would show it. Moreover, when interexchange carriers entered these markets in the past, they started with a small initial market share, required substantial use of LEC access

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[101] That the FCC is of the opinion that anticompetitive behavior has not been a significant problem in these markets is suggested by the fact that when, in September 1990, it placed these interLATA services provided by LECs under price caps, it elected not to subject them to price floors, as it had in other such decisions.

[102] Estimated from Paul Kagan Associates, Inc. *Wireless Market Stats*, No. 72, August 31, 1995, pp. 6, 13.

[103] The 1995 number reflects direct competition among the former BOCs except for Pacific Telesis, which spun off its cellular company (now known as AirTouch Cellular).

[104] J.A. Hausman and T.J. Tardiff, "Benefits and Costs of Vertical Integration of Basic and Enhanced Telecommunications Services," April 6, 1995, p. 5.

facilities, did not have complete dialing parity in any LATA, and had to compete against inexpensive local calling within the LATA and to overcome the imperfectly perceived difference between local and long distance calling.[105] In comparison, BOC affiliates entering the interLATA business would have only regional facilities and customer base, no dialing advantage, and no initial market share. The success of competition for intraLATA long distance is strong evidence that the theoretical problems of discriminatory treatment of BOC affiliates and their competitors are adequately addressed by existing regulatory safeguards.

In sum, regulators need not rely on either a priori reasoning or discussions of regulatory rules to conclude that there is no significant danger of LEC anticompetitive discrimination. Years of experience of the LECs competing with other companies have provided no evidence that they have succeeded in suppressing competition.

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[105] Even under these circumstances, LECs lost significant amounts of market share, particularly for large business customers that combine interLATA and intraLATA traffic on the same dedicated facilities. Although market share data are not generally available, revenue data suggest that such losses may be fairly widespread: from 1988 to 1991, LEC annual toll revenues were about $15 billion. By 1994 they had declined to only $13 billion; and, in 1995 they were only about $11 billion. In contrast total IXC toll revenues in 1989 were about $51 billion. By 1994 they increased to $67 billion; and in 1995 they rose to $72 billion. See Table 5 - Total Toll Service Revenues, *FCC Releases Report on Long Distance Market*, September 27, 1996, p. 11.

ATTACHMENT 4

The Depreciation Shortfall
Reply Comments

Jeffrey H. Rohlfs
Charles L. Jackson
Ross M. Richardson

USTA Reply Comments
CC Docket No. 96-262
February 14, 1997

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The Depreciation Shortfall

Reply Comments

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February 13, 1997

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Table of Contents

Abstract

In our previous filing in this proceeding we adduced a variety of evidence to quantify the depreciation shortfall. Richard B. Lee filed a study on behalf of AT&T to minimize the capital-recovery problem. However, Lee's analysis inappropriately focuses on accounting issues and does not adequately address economic depreciation. Moreover, Lee's study is belied by AT&T's own depreciation practices.

AT&T's filing argues that LECs should not be allowed to fully recover their costs. That approach involves abrogating explicit and implicit commitments that regulators made to investors. The policy would have a chilling effect on telecommunications investment and would be poor public policy.

Patricia D. Kravtin and Lee L. Selwyn also filed a study on behalf of AT&T. Their studies of the vintages and composition of LEC investment were intended to minimize the capital recovery problem. In reality, the studies provide little or no support for that position.

Kravtin and Selwyn also filed a utilization study to demonstrate that LEC plant is overbuilt. In reality, the study simply embodies:

- Their Luddite-like view that LECs should not have changed over from analog to digital switching technology; and
- Their view (for which they adduce no evidence whatever) that LECs maintain excessive spare loop capacity.

Furthermore, the Kravtin-Selwyn study defines excess capacity in relation to an inappropriately narrow definition of basic service. All in all, the study is seriously flawed and does not support the conclusion that LEC plant is overbuilt.

I. Introduction

Past regulatory depreciation of LECs has not adequately reflected declines in economic value of plant. As a result, there is currently a large depreciation shortfall. In our previous filing in this proceeding, we adduced a variety of evidence to quantify the shortfall. We discussed estimates of "theoretical reserves" developed by the price-cap LECs that are fully-subject to depreciation regulation. The LEC estimates are based on accounting methodology. According to those estimates, the depreciation shortfall is 7 percent of gross plant or $18 billion. We explained why we believe that this estimate of the depreciation shortfall is conservatively low. The actual disparity between regulatory book value of net plant and the economic value of LEC capital may substantially exceed the LECs' estimates.[1]

AT&T has also offered advice to the Commission regarding LEC capital recovery.[2] AT&T minimizes the problem of inadequate capital recovery and filed a study by Richard B. Lee[3] to buttress that position. Then, relying on studies by Patricia D. Kravtin and Lee L. Selwyn,[4] AT&T

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[1] Jeffrey H. Rohlfs, Charles L. Jackson and Ross M. Richardson, "The Depreciation Shortfall," filed before the Federal Communications Commission (FCC), CC Docket No. 96-262, *USTA Comments*, January 29, 1997, Attachment 15.

[2] FCC, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, and Usage of the Public Switched Network by Information Service and Internet Access Providers, CC Docket Nos. 96-262, 94-1, 91-213 and 96-263, *Comments of AT&T Corp.*, January 29, 1997.

[3] Richard B. Lee, "Analysis of Local Exchange Carrier Depreciation Reserve Levels," filed before the FCC on behalf of AT&T, CC Docket No. 96-262, January 29, 1997, Appendix C.

[4] Lee L. Selwyn and Patricia D. Kravtin, *Analysis of Incumbent LEC Embedded Investment: An Empirical Perspective on the "Gap" between Historic Costs and Forward-looking TSLRIC*, prepared on behalf of AT&T, filed before the FCC, CC Docket No. 96-98, May 30, 1996; and *Assessing Incumbent LEC Claims to Special Revenue Recovery Mechanisms: Revenue opportunities, market assessments, and further empirical analysis of the "Gap" between embedded and forward-looking costs*, prepared on behalf of AT&T, filed before the FCC, CC

(continued...)

concludes that LECs are not entitled to fully recover their costs. AT&T recommends that instead of allowing LECs to recover their invested capital, the Commission should declare a dividend of up to $10 billion per year to consumers (actually to interexchange carriers). In the instant filing, we rebut the studies by Lee and Kravtin-Selwyn.

II. Lee Study

The Lee study addresses depreciation issues primarily in accounting terms. It deals with economic depreciation only perfunctorily.[5] Such treatment is inadequate for regulatory policy in today's telecommunications markets. As LEC markets become more competitive, the regulatory book value of plant should approximate economic value. Otherwise, LECs will not be able to compete with equally-efficient entrants. Economic depreciation is all the more essential if LECs are required to sell unbundled components at cost-based rates. These arguments are developed more fully in our previous filing.

Furthermore, Lee's conclusion that LEC capital recovery has been adequate is belied by AT&T's own depreciation practices. AT&T depreciates the same types of plant much more rapidly than LECs. AT&T's overall depreciation rate is 53 percent higher than the LECs'.[6]

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[4] (...continued)
Docket No. 96-262, January 29, 1997.

[5] Lee concedes that the economic value of digital switching may have declined as a result of falling equipment prices. However, he claims that replacement cost for outside plant exceeds original cost. Lee's one paragraph analysis of this issue does not consider the possible replacement of copper cable with fiber-optics and loop-carrier systems. We discussed this issue in our previous filing.

[6] *See* "The Depreciation Shortfall."